The Institute for Advanced Financial Education™

COMMENT

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# TOTAL REMUNERATION EXTENDS BEYOND SALARY

While the old adage says "cash is king," employee benefits are a much-loved form of compensation that should not be overlooked. Whether considering a job offer or comparing remuneration packages, total compensation takes into account far more than just salary. Benefits are often the differentiating factor.

What is easy to forget is that benefits come with a cost and that cost is typically converted into a dollar value that is reported on a taxpayer's T4 statement. A benefit is a good or service that employers provide to employees, such as a fitness membership at the local gym. Benefits also include an allowance or reimbursement to employees for personal expenses.

An allowance, for example, is a sum of money provided to an employee in anticipation of the employee undertaking an activity but the employee is not required to substantiate the cost of that activity. A monthly travel allowance for those who use their vehicle for work-related travel or a meal allowance are examples of an allowance that represents remuneration and are generally required to be reported on the employee's annual T4 statement. There may be circumstances where the employee may be eligible to deduct actual expenses incurred, depending on the circumstances; nonetheless, allowances are typically required to be included in income as a separate requirement from any eligible deductible offsetting expenses.

An allowance is typically differentiated from a direct reimbursement of actual costs such as a reasonable mileage reimbursement paid to an employee for tangible documented work-related travel. This could involve reimbursing an employee for driving from the office to a client's worksite when required as part of the employee's duties. The Canada Revenue Agency's (CRA) 2018 reasonable mileage reimbursement is $0.55 per kilometre for the first 5,000 kilometres driven and $0.49 per kilometre driven beyond the first 5,000.

Other examples that would generally fall into the taxable benefit category include free or subsidized board or lodging. Employer-paid premiums for group life insurance are a taxable benefit to an employee as are any premiums an employer pays for non-group life insurance or optional dependent life insurance.

Examples of a few benefits that are not treated as taxable include subsidized meals where employees pay a reasonable charge. There are specific categories of expenses associated with an employee moving or relocating because of a job transfer that do not give rise to a taxable benefit.

A high profile benefit that does not attract income tax consequences is the payment of premiums by an employer for private health services plans, which are more commonly known as group health/medical and dental plans. Just prior to the 2017 federal budget, there were rumours that the federal government was considering shifting their stance and making employer-paid private health plans a taxable benefit. These rumours caused sufficient concern amongst taxpayers who opposed the idea, that the federal government made an announcement that the plans would remain non-taxable.

In simple terms, taxable benefits arise when there is an economic benefit to the employee unless there is a specific exception permitted. An example of an exception accepted by the courts is when an employee is the recipient of something but the primary beneficiary is the employer. A recent case, *Mark Smith v. The Queen*, involved this precise argument. The CRA had assessed a taxable benefit on the taxpayer, Mark Smith, for the value of the parking pass provided to him by his employer. The taxpayer appealed the assessment, arguing in the Tax Court of Canada, that the parking pass was for the benefit of his employer, not for his own benefit.

The facts, as outlined below, were fairly straight forward.

- The taxpayer, Mr. Smith, was a flight attendant working for Jazz, a subsidiary of Air Canada.
- Jazz provided a connector service for Air Canada, moving passengers between small airports and larger international airports.
- Part of Jazz's compensation for its services to Air Canada involved an incentive for on-time performance. The proportion of flights that departed on time was included in the calculation of the incentive paid to Jazz by Air Canada.

- Flight crews accounted for the largest proportion of Jazz's costs.

- These two variables – the on-time incentive and careful expense control management at Jazz-suggested that the timely arrival of flight attendants when reporting for duty was an important element of the company's financial success.

- Flights were typically staffed with the minimum number of attendants. As such, flights could not depart if an attendant failed to arrive for work. To mitigate the impact, the airline would pull an attendant from a later scheduled flight. They would then call one of their on-call attendants who were required to report for duty within two hours of receiving a call. On-call attendants represented about 10 percent of the company's workforce.

- The company promoted an on-time culture through the payment of on-time bonuses.

- While the flight attendants were not required to have a car as a condition of employment, the company provided parking passes to all flight attendants. Parking passes were commonly provided to employees of other airlines at the same airport.

- There was evidence presented that the collective agreement required Jazz to provide parking passes to all flight attendants and that this requirement had been in place for at least 18 years.

- The taxpayer confirmed he did not require his car to perform his duties as a flight attendant and that he opted to drive to work rather than use other forms of transportation. He confirmed if his employer did not pay for the parking pass, he would have considered other options.

- The taxpayer explained that his employer had a policy that if an employee was late three times, he would be terminated.

In analyzing the facts of the case, the judge concluded that there was no evidence to substantiate a correlation between the use of the parking pass and any benefit to Jazz, the taxpayer's employer. While a representative of Jazz suggested the parking pass was valuable to helping ensure flight attendants arrived on-time and therefore contributed to the company's financial success, the judge stated there was no valid evidence to support this conclusion or to quantify the financial impact to Jazz.

The court upheld the CRA's assessment. Using a balance of probabilities, the judge found that the primary beneficiary of the parking pass was Mr. Smith as he received an economic benefit from having the parking pass and that it was measurable in economic terms.

Taxable benefits can be considered an equalizer as they help ensure that negotiations between an employee and employer cannot easily shift elements of total compensation into non-taxable benefits.

## CANADIAN GENEROSITY

Canadians contribute to charitable organizations in a wide variety of ways, one of which is monetary donations where official receipts are issued so the taxpayer may claim tax credits available through the income tax system.

Based on 2016 Canadian tax filings, Canadians donated nearly $9 billion dollars. Out of 26.3 million taxpayers, approximately 5.4 million claimed a donation tax credit. The median donation amount was $300, which means half of all taxpayers who claimed the credit donated less than $300 and the other half donated more than $300.

The average amount claimed as a donation tax credit shows an upward trajectory as the age of the donator increases. For example, donors aged 24 and under donated an average of $420, whereas the average donation amount nearly doubles to $830 for donors aged 25 to 34. This upward trend continues as the age bands increase – ages 35 to 44 averaged $1,220, ages 45 to 54 averaged $1,560, ages 55 to 64 averaged $1,800 and ages 65 and over capped off at $2,250.

The Canada Revenue Agency (CRA) is responsible for regulating charities including processing applications for registration, managing audit and compliance activities as they relate to registered charities and providing general information to the public. A charity must be registered with the CRA in order to issue official donation receipts for income tax purposes. To qualify for and maintain registration, the organization's charitable purpose must fall into one or more of the following activities:

- the relief of poverty;
- the advancement of education;
- the advancement of religion; and,
- other purposes that benefit the community.

The establishment and ongoing operation of a registered charity must be exclusively for charitable purposes. Upon registration, the CRA issues a charitable registration number that needs to appear on all receipts. An annual information return (Registered Charity

Information Return) must be filed within six months of a charity's fiscal period-end.

The CRA makes an extensive array of information about all registered charities available to the general public on the CRA's website through a searchable list. Updated daily, the searchable database allows the public to confirm an organization's current status - registered, revoked, annulled, penalized, or suspended.

The searchable list includes information from the charity's information return such as contact information, general activities and a variety of financial data. This increasingly transparent approach provides potential donors with easily accessible information that can be helpful before finalizing donation decisions.

## CORPORATE OWNERSHIP OF A LIFE INSURANCE POLICY

Ownership of a life insurance policy comes with choices. Should the policy be held in an individual's name or should it be held by the corporation? Corporate ownership can provide some distinct advantages, but it can also have less favourable consequences that should be observed.

When a life insurance policy is owned by a corporation, the shareholder should not be designated as beneficiary of any proceeds, in order to avoid shareholder benefit issues.

### Advantages

One of the biggest advantages of corporate-owned life insurance is that the 'cost' of the premiums is lower than when personally-owned. Generally, the payment of a life insurance premium is not a permitted tax deductible expense for the corporation. Similarly, individuals pay for life insurance with after-tax dollars. Therefore, when determining the best economic value, it makes sense that the entity in the lowest tax bracket should pay the premium as it requires the least pre-tax income to fund the payment. The corporation is typically the more optimal ownership scenario when evaluating economic cost.

The formula to determine the amount of pre-tax income required is: Premium ÷ (1 - tax rate). Let's look at an economic comparison where the annual premium for the life insurance policy is $12,000. Keep in mind that the $12,000 premium is the same, regardless of how ownership of the policy is structured.

**Economic Comparison**

| | Scenario A<br>Corporate-Owned | Scenario B<br>Corporate-Owned | Scenario C<br>Personally-Owned |
|---|---|---|---|
| | Income taxed at low-active business income tax rate | Income taxed at high-active business income tax rate | Taxpayer in 50% marginal tax rate bracket |
| **Premium** | $12,000 | $12,000 | $12,000 |
| **Tax rate** | 15% | 26% | 50% |
| **Pre-tax income required to net sufficient after-tax income to pay the premium** | $14,117 | $16,216 | $24,000 |

In scenario C, a personally-owned insurance policy, it takes $24,000 of pre-tax income to accumulate the required $12,000 of after-tax income in order to pay the premium. Alternatively, if the insurance were owned by a corporation whose income is taxed at the low-active business income rate, scenario A, the corporation would need to earn only $14,117 of pre-tax income.
The required pre-tax income increases slightly to $16,216 in scenario B where the corporation uses income taxed at the high-active business income rate.

In many private company situations, it is the corporation that generates the cash flow for the shareholders and their families. By having the life insurance policies held by the corporation, the premium obligation lies with the corporation, which can then use corporate cash flow to fund the payment.

Another advantage of corporate-owned life insurance is that it creates a credit to the corporation's capital dividend account (CDA) when any life insurance proceeds are received. In general terms, the credit to the corporation's CDA is equal to the life insurance proceeds received in excess of the life insurance policy's adjusted cost basis. Unlike taxable dividends, a dividend paid from the corporation's CDA is non-taxable to Canadian shareholders. Capital dividends can be distributed as a tax-free payment to shareholders or could be used in the shareholders' post-mortem planning to minimize the tax liability triggered by death.

Corporate-owned life insurance could be used to equalize inheritances. For example, the life insurance proceeds could be used to buy-out those family members who will not continue to be involved in the family business following the death of the life insured. The transaction could be structured to ensure that departing family members receive an equal value relative to what the other family members receive.

Life insurance shares could be utilized to stream life insurance proceeds to certain shareholders as part of the family's overall wealth transfer plan. Consider a family situation where the family's holding company owns a portfolio of life insurance policies on all of the family members. Share attributes could be structured such that a daughter's shares could be bequeathed to her surviving husband who would be entitled to receive the corporate insurance proceeds in respect of his spouse. The caveat to this strategy would be to take into consideration the value of the life insurance shares when they are issued and when they are disposed of.

Corporate-owned life insurance could be used to repay corporate debt. The corporation could redirect the cash from the insurance proceeds toward repayment of corporate debt. This repayment would not affect the CDA credit arising from the receipt of the proceeds, which would allow the corporation to distribute future earnings as tax-free dividends. Alternatively, the balance in the CDA could be used in post-mortem estate plans.

Corporate-owned life insurance could be used to fund the buy-sell arrangement portion of the shareholders' agreement. Properly structured, the corporate-owned life insurance could reduce the deceased shareholder's income tax consequences arising from death and the sale of their shares to the surviving partners.

## Disadvantages

The primary disadvantage of corporate ownership of a life insurance policy is the loss of creditor protection. When a life insurance policy is personally-owned and the beneficiary is an immediate family member, the policy is generally exempt from seizure by the policy owner's creditors. If the policy is owned by a corporation, the policy can be seized by the corporation's creditors.

Care needs to be exercised during corporate reorganizations or the sale of the corporation, as onerous income tax consequences can arise if it becomes necessary for the corporation to transfer ownership of the policy.

The cash value of a life insurance policy is a passive asset of the corporation. This means that care needs to be exercised when determining whether shares of the corporation meet the definition of a qualified small business corporation (QSBC) for purposes of the enhanced capital gains exemption. In addition, valuation of the company will be impacted by policy ownership. Examples where a valuation would be required include a non-arm's length transaction, a deemed disposition upon the death of the shareholder, a deemed disposition of the shares if the shareholder emigrates to another country, and for US estate tax purposes. The fair market value of any corporate-owned life insurance policy is a consideration when the insurance coverage is on the lives of arm's length non-shareholders.

It is important to analyze each situation carefully to ensure that the advantages are maximized and disadvantage are evaluated and minimized.

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